REPORT OF THE COMPTROLLER GENERAL OF THE UNITED STATES

An Evaluation Of The Federal Power Commission's Rulemaking On Utilities' Construction Work In Progress

GAO was asked to review a proposed Federal Power Commission rule to allow natural gas and electric utility companies to include construction work in progress in their bases for computing rates.

The rulemaking order does not appear to serve adequately either of the purposes the Commission originally envisioned. The immediate financial impact appears to be minimal, and little change will result in the utilities' allowances for funds used during construction accounts.

Of more importance, the rulemaking sets a precedent for the Commission to depart from its historic "used and useful" policy and provides an opening for utilities to submit future rate increase filings with cost of construction work in progress in the rate base.

EMD-77-7 DEC. 2.1976

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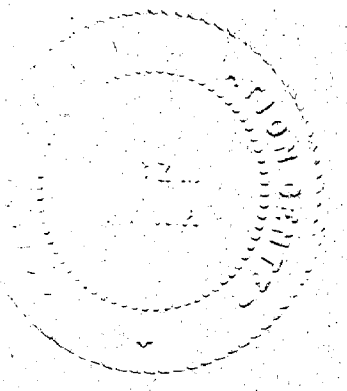

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U.S. General Accounting Office

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-180228

The Honorable John E. Moss
Chairman, Subcommittee on Oversight
and Investigations
Committee on Interstate and Foreign
Commerce
House of Representatives

Dear Mr. Chairman:

In a March 29, 1976, letter, you requested us to review the Federal Power Commission's proposed rulemaking, RM75-13, which would allow natural gas and electric utility companies to include construction work in progress in their rate bases. Because of your concern about the impact on consumers if the Commission ordered the rulemaking, you wanted us to determine (1) the propriety of the proposed rulemaking from the standpoints of procedure and necessity, (2) the benefits that will accrue to the utility industry if the proposed rulemaking goes into effect, and (3) the impact of the rulemaking on the rates currently being paid by utility customers.

On November 8, 1976, the Commission issued a modified version of the original rulemaking proposal which would become effective 30 days from the date of issuance unless the Commission granted a rehearing on the order. The rulemaking, Order No. 555, as approved by the Commission, contains three major provisions.

1. Natural gas pipeline companies are excluded from the Commission order.

2. The Commission will permit rate base treatment for pollution control and fuel conversion costs incurred by electric utilities in accordance with the terms outlined in the rulemaking.

3. An in extremis provision whereby under specified circumstances the Commission will permit, in individual proceedings, including construction work in progress in the rate base when the utility is in severe financial stress.

The Commission's actions in formulating, processing, and approving the proposed rulemaking, RM75-13, followed the legal requirements for rulemaking contained in the Administrative Procedures Act (5 U.S.C. 553) but some of the Commission's normal actions for initially proposing and processing a rulemaking

proposal were bypassed. For example, at the time RM75-13 was initiated, no analysis or study was prepared supporting the need for the rulemaking and no proposal was made as to how it would be implemented. Also, in contrast to normal procedures, the Commission office responsible for initiating the rulemaking proposal did not prepare a recommendation for Commission consideration following the staff analysis of the respondents' written comments.

However, later Commission memoranda and proposals did address the question of implementation, and recommendations for Commission consideration were prepared before the final order on the rulemaking. Therefore, except for no detailed analysis demonstrating the need for the rulemaking, the only apparent effect of the Commission not following normal procedures was the long period of uncertainty for the utility industry as to the actual resolution of the proposal.

The Commission did not maintain a complete central file containing all pertinent documentation on the proposed rulemaking. This lack of documentation made it difficult to follow the steps taken by the Commission in processing the rulemaking.

We believe that, although the Commission has broad discretion in a rulemaking procedure, its public responsibility dictates a recordkeeping system that not only provides sufficient information for staff use but also makes available to the public as much information as possible. We have recommended that the Chairman require a complete central file to be maintained for each rulemaking.

The Commission initiated the rulemaking to provide current financial relief to the utility industry. The Commission's assessment of the industry indicated that the utilities were suffering from an acute cash shortage and that utilities with large construction programs were having difficulty borrowing funds at favorable interest rates. The proposal to allow construction work in progress in the utilities' rate bases was expected to help overcome these financial problems.

As the Commissioners delayed taking final action on the proposed rulemaking, the financial condition of the utility industry as a whole began to improve and the current financial need of the utilities was not the focal point for the approved rulemaking order. Instead, the Commissioners

decided to only allow certain pollution control and conversion facility costs in the rate base because of the present generation's commitment to pollution control or the controlled consumption of existing stocks of natural resources. However, the Commissioners did not exclude the possibility that certain utilities might need financial help and included a provision in the final order that allows them to expand the rulemaking by authorizing other construction costs in the rate bases for utilities demonstrating financial hardship.

The Commission has excluded the natural gas companies from the effects of the rulemaking. It determined that the relatively small amount of the gas industries' construction work in progress account, the different method of financing large projects, and the uncertainty of the identity of future gas users justified the exclusion.

The Commission has consistently refused to allow construction work in progress in a utility company's rate base and failed to act even though many of the utilities were in poor financial condition in 1974 and 1975. Now that financial indicators show the utility industry to be much improved and able to compete in the market for funds, the Commission has elected to move ahead--on different grounds than originally envisioned--and allow at least some construction work in progress in the rate base. The financial impact of allowing certain environmental costs in rate base is not yet clear, but it does not appear to represent a large increase in either industry benefits or consumer costs. This is due in part to the fact that nearly one-half of the State commissions currently allow their jurisdictional utilities to include some or all construction work in progress costs in their rate bases. On the basis of the Commission's jurisdictional share of the utility industry, we estimated that, if the $1.558 billion in pollution control costs recorded as construction work in progress on December 31, 1975, were allowed in the utilities' rate bases, wholesale revenues would increase only by about $12 million, or 0.2 percent.

In our opinion, the rulemaking does little to achieve the purpose of the original proposal to provide substantial financial relief to the industry. However, it does establish a precedent for future Commission actions by removing

the "used and useful" 1/ restrictions that governed prior Commission construction work in progress policy.

The potential impact of the in extremis provisions to permit construction work in progress in the rate base of a utility demonstrating a severe financial situation appears to be much more important. Utilities with large construction programs and in a poor financial condition could submit a rate increase filing with construction work in progress in in the rate base. Commission approval of the requested increase could considerably raise wholesale rates to customers, particularly if the Commission had jurisdiction over much of the utility's operations. Although the provision allows The Commission to take prompt action to provide relief to utilities in financial trouble, the incentive for a utility company to operate in an efficient and prudent manner would appear to be reduced.

Commission approval of the rulemaking raises the prospect that the administrative workload of the staff will increase as a result of more complex rate increase filings. The Commission staff will now have to accept all rate filings that include construction work in progress costs in the rate base. Through staff analysis and possibly the full hearing process, the reasonableness of the filing, including a determination of financial need, will have to be decided, and allowing construction work in progress in the filing might require additional time to resolve differences between the utility and any intervenors contesting the rate filing.

A more detailed discussion of these matters is presented in appendix I.

Although your staff requested that the report not be submitted for formal agency comments, we did discuss it informally with the Commission Chairman and his assistant. Their comments have been included in our report as considered appropriate.

This report contains a recommendation to the Commission which is set forth on page 10. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions

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1/It has been Commission policy not to allow construction work in progress in the rate base until such time as the facility is completed and put into service.

taken on our recommendations to the House and Senate Committees on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We will be in touch with your office in the near future to arrange for the release of the report to meet the requirements of section 236.

Sincerely yours,

Comptroller General
of the United States

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APPENDIX I

THE COMPTROLLER GENERAL'S REPORT ON AN EVALUATION OF THE FEDERAL POWER COMMISSION'S RULEMAKING ON UTILITIES' CONSTRUCTION WORK IN PROGRESS

REVIEW OF FPC'S PROPOSED RULEMAKING TO ALLOW CONSTRUCTION WORK IN PROGRESS IN UTILITIES' RATE BASES

The Federal Power Commission (FPC), as one of the major independent regulatory agencies in the Federal Government, regulates the interstate aspects of the electric power and natural gas industries. Its regulatory policies and decisions directly or indirectly affect the great majority of U.S. consumers of electricity or natural gas.

In addition to using its adjudicative procedures, FPC establishes or amends its policies through the rulemaking process, an accepted method backed by abundant legal authority. One example of this procedure is a policy change concerning the treatment of utilities' construction work in progress account. FPC has approved a modified version of the proposed rulemaking, Docket No. RM75-13, Amendments to Uniform System of Accounts for public utilities and licensees and for natural gas companies (classes A, B, C and D) and regulations under the Federal Power Act and the Natural Gas Act, to include construction work in progress in rate base. FPC first released the rulemaking proposal for public comment on November 14, 1974. Final approval of the modified version was given at an FPC meeting held November 2, 1976, and Order No. 555 was issued on November 8, 1976.

At the request of Chairman John E. Moss, we reviewed the entire rulemaking process in terms of FPC compliance with legal or established procedures, necessity for the rulemaking, and the impact of the rulemaking on utility companies and their customers.

RULEMAKING--LEGAL AUTHORITY AND REQUIREMENTS

A rule (or a regulation--a term used interchangeably with rule) is the product of rulemaking, and rulemaking is part of the administrative process resembling a legislature's enactment of a statute. Rules established pursuant to a grant of power to make law through this procedure have the same force as statutes if they are valid. The three tests of validity are constitutionality, statutory authority, and proper procedure.

Federal agencies are required to follow the rulemaking procedures contained in the Administrative

Procedures Act, (5 U.S.C. 553). General notice of proposed rulemaking is to be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise notified. After the notice has been published, the agency gives interested persons an opportunity to comment on the rulemaking through submission of written data, views, or arguments, with or without opportunity for oral presentation. After considering the relevant matter presented, the agency incorporates in the rules adopted a concise general statement of their basis and purpose. A new rule generally cannot become effective until 30 days after publication and each agency gives an interested person the right to petition for the issuance, amendment, or repeal of a rule.

Procedurally, no requirements are placed on Federal agencies before the time the notice of proposed rulemaking is published in the Federal Register. In other words, agencies are not required to maintain any documentation supporting or justifying a decision to propose a rule.

ASSESSMENT OF PROCEDURES FOLLOWED IN PROPOSED RULEMAKING

The procedures FPC followed in RM75-13 were legally in conformance with the requirements of the Administrative Procedures Act, but the initial steps in proposing and processing the rulemaking deviated somewhat from the procedures generally followed in other FPC rulemaking proceedings. Since FPC actions before the final approval of the rulemaking proposal addressed the issues not previously covered, the only apparent effect of the deviation from normal procedures was the long period of uncertainty for the utility industry as to FPC's eventual resolution of the rulemaking.

We found that the FPC's central files which should contain complete records of all data pertaining to the rulemaking were of little use in determining the rationale for and later processing procedures of the rulemaking proposal. We recognize that FPC has broad discretion in a rulemaking proceeding but believe that its public responsibility dictates a better recordkeeping system. Therefore, we believe that action should be taken to improve the central file system.

Internal procedures generally followed by FPC

FPC has few formal procedures other than those contained in the Administrative Procedures Act.

However, we found that its practices in rulemaking cases generally follow a consistent pattern.

According to FPC officials, a rulemaking is generally initiated with a memorandum to the Commissioners from one or more of the departments within FPC. They told us that the department that submits a recommendation for a rulemaking proposal usually makes some type of analysis or study supporting the need for the rulemaking. In the event of a proposed change in the Commission's Uniform System of Accounts--as RM75-13 was initially considered to be--the proposal may even be discussed with utility industry and State utility commission representatives and their views considered in making the proposal. However, the FPC's only formal justification supplied to the public is contained in the notice of proposed rulemaking.

According to FPC's General Counsel, the Commissioners consider the initiating memorandum and, if the recommendations are approved, the memorandum is referred to the Office of General Counsel or back to the department initiating the rulemaking. An attorney from the Office of the General Counsel or a member of the department initiating the rulemaking is then assigned to review the proposal, all pertinent statutory provisions, and prior FPC decisions which would be affected by, or have some bearing on, the proceeding. The person assigned then prepares a notice of proposed rulemaking for final action. The proposal is reviewed by the appropriate person within the Office of General Counsel with review responsibilities--an assistant to the General Counsel or some other senior lawyer having responsibility over the subject-matter of the proceeding. The followup review is conducted by the head of the department initiating the rulemaking, the General Counsel, and finally, the Commissioners. After Commissioner approval, the proposed rule is published in the Federal Register as indicated.

We were told that normally the bureau or office that makes the original recommendation for the rulemaking is also given the responsibility for analyzing the written comments submitted by respondents to the rulemaking and recommending the action to be taken by the Commissioners. In addition to receiving written comments on a proposed rulemaking, the Commissioners can order a formal hearing or hold oral arguments. In such cases the secretary issues a public notice and fixes the date by which outside parties may request permission to participate. These hearings are open to the public.

The written comments and oral arguments are then considered by FPC staff and an order promulgating the rule is prepared by the responsible party and reviewed by the Office of General Counsel. The order incorporates the basis and purpose of the adopted rule and is subject to the same approval noted above in connection with the issuance of a notice. Following Commissioner approval, the order is then issued.

According to FPC's General Counsel, the time that elapses between the first overt act towards drawing up a rule and the date of publication of the notice in the Federal Register varies from rule to rule and depends on the degree of complexity and urgency of the proposal.

FPC maintains a central file of all cases accepted for processing. These docket files are separated into public and nonpublic categories with specific data records kept in each file. However, all data that pertains to a specific docket is to be in either one or the other file.

Procedures for RM75-13 deviated from normal pattern

As indicated previously, a rulemaking proceeding is generally initiated with a memorandum from one or more of the departments within FPC. In the case of RM75-13, the directive to prepare the proposed rulemaking originated with the Commissioners. However, the timing and sequence of events surrounding the proposal was not clear because FPC did not have a complete record of rulemaking proceedings in one central file location. Individual Commissioners or FPC staff that participated in preparing rulemaking documentation generally kept copies of their own contribution, but even these were not always readily available.

The only written record available was an FPC staff memorandum, dated August 29, 1974, which stated that the Commissioners had directed the Office of Accounting and Finance (OAF) to prepare a rulemaking on construction work in progress for their consideration. FPC's General Counsel said that the proposal was made by the former FPC Chairman during a Commissioners' meeting in August 1974. The former Chairman concurred in this statement but emphasized that he had spoken for all Commissioners in making the request to OAF and it was not a unilateral decision on his part.

This method of originating a rulemaking is somewhat unusual, because a rulemaking is generally initiated by a memorandum to the Commissioners with the need for the

rulemaking supported by some type of analysis or study. No analysis or study supporting the propose rulemaking was available to the Commissioners before requesting the proposal nor were they prepared by the OAF staff given the responsibility for drafting the proposal.

However, an FPC official stated that two studies concerned with the financial condition of the electric utility industry were publicly released in September 1974. One study, prepared by FPC's Office of Economics, analyzed the financial requirements of the electric utility industry for the period 1975-79 and identified means of meeting them. The study also analyzed the relative impacts of a number of policy alternatives of these financial requirements. The second study was prepared by OAF staff who were not involved in preparing the rulemaking proposal. This study was similar to the Office of Economics study and examined the present and prospective financing problems of the electric utility industry. It offered eight policy options that FPC and State regulatory commissions could consider to enable the industry to meet the challenges of the future. The FPC official could not identify a direct relationship between these studies issued in September 1974 and the preparation of the proposed rulemaking a month earlier. He did say that the Commissioners were no doubt aware of these studies as they deliberated the proposed rulemaking in the fall of 1974.

The notice of proposed rulemaking, as published in the Federal Register, contained no plan for implementing the rule if adopted. OAF's Chief Accountant said this was unusual, although FPC's General Counsel said that an implementation plan was to be determined after comments had been received on the proposed rulemaking. We noted that one of the major difficulties FPC faced in agreeing on an acceptable rulemaking was the resolution of the implementation question.

FPC received 160 written comments on the proposed rulemaking. The comments displayed a sharp division of opinion on the FPC proposal. Virtually all regulatory private electric utilities and gas pipelines supported the proposal; consumer groups, electric cooperatives, and publicly owned systems were strongly opposed. The comments also disclosed various administrative problems, incentive effects, and potentially discriminatory results.

FPC action taken after receipt of written comments on RM75-13 seemed to deviate from their normal procedure of analyzing the written comments and forwarding them with a recommended rulemaking to the Commissioners for consideration.

The Commission Chairman requested that OAF prepare a preliminary assessment of the 160 written comments. This was completed and sent to the Commissioners on June 30, 1975. The item was put on their agenda for July 11 and July 30, but the matter was not discussed either time.

Following the preliminary assessment, the OAF staff made their detailed analysis of the comments and prepared a draft proposal of the rulemaking (this step followed normal procedures). This August 18, 1975, draft was circulated for comment among cognizant FPC offices. On the basis of the comments received, a final draft proposal was prepared recommending that the rulemaking be implemented on an ad hoc basis. However, the OAF chief accountant, as final reviewing officer, did not agree with the staff recommendation. He felt the rulemaking was a policy not an accounting matter and that OAF should not make a recommendation on the proposal. Consequently, on December 8, 1975, he forwarded to the Commissioners only the staff analysis of the written comments.

Later actions taken on the proposed rulemaking

OAF's analysis of the comments was placed on the agenda for discussion on December 10, 1975. The discussion was postponed until December 17 and again until December 31. Our review of these agendas and discussion with responsible FPC staff indicated that the rulemaking issue did not appear on the December 31 agenda and was not formally discussed until July 14, 1976.

Although RM75-13 was not discussed in a Commissioners' meeting until the July date, they apparently accepted OAF's assessment that the rulemaking was not an accounting problem. Memoranda covering various aspects of the rulemaking submitted after December 8, 1975, were prepared by FPC offices other than OAF.

On December 17, 1975, staff members from FPC's Office of Economics submitted a memorandum discussing the extent to which treatment of construction work in progress (CWIP) may affect management decisions concerning types of electric-generating plants to be built (no conclusion was reached). On December 18, 1975, the Assistant General Counsel forwarded a memorandum supporting his opinion that no legal bar exists to including CWIP in utilities' rate bases.

The Chief, Office of Economics, submitted a second memorandum, dated December 22, 1975, in which he reviewed certain respondents' written comments and offered the conclusion

"* * * that it would be inadvisable for the Commission to adopt a general policy of rate base treatment for CWIP. Instead, I would recommend requiring a utility desiring CWIP in rate base to demonstrate special circumstances (e.g., major obstacles to new financing, compatability with state regulation, exceptionally heavy CWIP financing)."

Following the receipt of the above memorandums, FPC announced on January 23, 1976, that it would hold oral arguments on the proposed rulemaking in New York City on March 8, 1976. The oral argument was held as scheduled with 50 respondents participating.

On March 5, 1976, just before the oral arguments were held, the Chief, Division of Economic Studies, Office of Economics, submitted a memorandum to FPC at the Chairman's request. He presented a brief analysis of the financial effects of putting CWIP in the rate base, generally repeating points that had been covered in respondents' replies to the initial proposal.

Following the completion of the oral arguments on March 8, 1976, the FPC Chairman gave his assistant and the Chief, Division of Economic Studies, Office of Economics, the responsibility for analyzing the oral arguments and preparing a draft order on the proposed rulemaking for Commissioners' consideration. Two memorandums for Commissioners' information were prepared on March 18 and 26, 1976, which set forth Office of Economics thought. These memorandums served as the basis for a draft proposal that was offered for consideration at a July 14, 1976, Commissioner meeting. Basically, the proposal excluded gas pipeline companies from the rulemaking, allowed in the rate base all costs incurred by utilities for pollution control devices and for converting facilities from gas to oil or coal and oil to coal, and stated FPC would consider including other CWIP costs in the rate base if 50 percent or more of the sales of the affected company are subject to FPC jurisdiction or to the jurisdiction of States that allow CWIP in rate bases. However, the CWIP costs that would be considered were limited to that amount necessary to bring the company's pretax interest coverage ratio to 2.5 using the following computation:

$$\frac{\text{(Operating income + Federal taxes)}}{\text{Interest expense}}$$

Natural gas companies were excluded from the rulemaking because FPC determined that the relatively small amount of the gas industries' CWIP accounts, the different method of financing large projects, and the uncertainty of the identity of future gas users justified the exclusion. Costs for pollution control devices and conversion facilities were justified on the basis of FPC's assessment that the present generation caused the pollution requiring the controls and it has recognized the need for containing the pollution.

The Commissioners considered the draft proposal on July 14, 1976, and again on July 16, 1976. The Commissioners all agreed that pollution control and conversion costs should be allowed in the rate base. The majority agreed there should be some test for allowing other CWIP costs in the rate base but they had questions concerning the test criteria as stated in the rulemaking proposal. Therefore, no final vote was taken and the Chairman referred the draft proposal back to the staff for additional work.

On September 15, 1976, the Commission discussed two staff memorandums concerned with the proposed rulemaking. Both the Bureau of Power and Office of Economics staff that prepared the memorandums favored allowing pollution control and conversion costs in the rate base but did not propose retaining the test criteria as given in the July proposal. The Commissioners present agreed with the staff position but again delayed making a final decision.

On September 29, 1976, the Commissioners discussed a revised draft proposal that reflected FPC's concern over allowing utility companies to include CWIP in their rate bases if they met certain prescribed tests. This test requirement was deleted in its entirety, and it was proposed that only pollution control or conversion costs would be allowed in rate bases. Gas pipeline companies were still excluded and an open-end clause was added by which the Commissioners reserved the right to make future decisions on allowing other CWIP costs in rate bases. The proposal was generally acceptable to the Commissioners, but they wanted some estimate of the potential impact and a better definition of exactly what items would be included in rate bases. Consequently, the Commissioners again delayed taking a final vote.

The proposed rulemaking was next discussed on October 6, 1976. General agreement was reached with the exception of one objection to the open-end clause giving the Commissioners the right to add other CWIP costs in the future. Discussion

of that issue was postponed until the meeting scheduled for October 13, 1976.

The rulemaking proposal was not discussed at the October 13, 1976, meeting as scheduled. On October 20, 1976, the Commissioners discussed (1) the revisions made to the September 24, 1976, draft (2) a new proposal that limited rate base treatment of CWIP to pollution control and conversion retrofitting costs and excluded the open-end clause, and (3) an in extremis clause to the new proposal that authorized the Commissioners to permit, in individual proceedings, including CWIP in a rate base when the utility was in severe financial stress. Faced with the choice of making a selection from the three options, the Commissioners agreed to delay the decision for 1 additional week.

On November 2, 1976, after acknowledging the fact that there would be a rehearing on the order, a majority of the Commissioners voted to accept the rulemaking proposal that limited rate base treatment to pollution control and conversion costs as amended by the in extremis provision. The rulemaking order was issued on November 8, 1976.

Conclusions

We recognize that FPC has broad discretion in how it proceeds in the rulemaking process and that relatively few steps are legally required. In our opinion, however, the deviations from normally followed FPC procedures in initially proposing and processing the draft CWIP rulemaking order did not provide the Commissioners with sufficient information to act expeditiously on the rulemaking proposal. This had the effect of lengthening the time required for FPC to act on the proposal and extended the period of uncertainty for the utility industry as to the final resolution of the rulemaking proposal.

Also, in view of FPC's responsibility to keep the public informed of its activities and to act in an efficient manner, we believe that good management practices that go beyond the legal requirements should be followed when using rulemaking procedures.

These practices should include not only preparing pertinent documentation charting FPC actions, but also maintaining a complete central file accessible to both the public and FPC staff.

Recommendation to the Chairman, FPC

We recommend that the Chairman, FPC, require that a complete central file be maintained for each rulemaking. In our opinion, this file should contain all memoranda, studies, analyses, or other documentation pertaining to the rulemaking and should be readily available to all interested parties. The present distinction between data filed in the nonpublic versus the public file should be reexamined with as much data as possible made available to the public.

Agency comments and our evaluation

In commenting informally on our recommendation the FPC Chairman recognized the need to improve the administrative organization, including the central files, at FPC. He said that on September 23, 1976, he approved Administrative Order No. 161 which established the Office of Regulatory Support Services. This office will be responsible for providing skilled professional records management services for FPC, including processing and controlling the official FPC dockets and central files.

We found that under Order No. 161 the FPC staff made preliminary plans to improve the records management services, although the implementation method is still uncertain. One part of the plan relates directly to our concern about central file content and if properly implemented should resolve the central file issue.

NECESSITY FOR IMPLEMENTING THE PROPOSED RULEMAKING

The Federal Power Commission's initial and primary purpose for allowing CWIP in a utility's rate base was "to help alleviate the current financing problems being experienced by utility companies." The extremely unfavorable money market conditions of 1974 prompted FPC to propose including CWIP in the rate base to lessen utilities' cash flow problems.

As the Commissioners delayed taking final action on the proposed rulemaking, the financial condition of the utility industry as a whole began to improve. Our analysis of current financial data provided by FPC and obtained from publications of various financial services indicates that the problems faced by the electric utility industry in 1974 have diminished. This view was supported by an OAF study completed in July 1976. The improved financial condition of the industry, therefore, raises questions as to whether the rulemaking was really needed.

APPENDIX I

Studies in 1974 disclosed utilities' financial problems

Before publishing the Notice of Proposed Rulemaking in November 1974, FPC issued two studies analyzing the current and prospective conditions of the electric utility industry. FPC focused on the electric utility industry because it felt that the financial problems of the electric utilities were more severe than those of the natural gas companies. Consequently, there were no studies of the financial condition of natural gas companies.

The studies discussed the effect on the electric utility industry of inflation, high interest rates, and other factors with reference to their impact on future financial requirements. The studies also contained assessments of various policy alternatives which, if implemented, would affect utilities' financial conditions.

One study prepared by OAF analyzed 116 electric companies from an operational, financial, and market viewpoint. The study also used FPC data on class A 1/ and B 2/ electric utilities as an aggregate group. OAF examined the trends of the following financial indicators, for the period 1969-73, which it believed best measured the financial capability of each company:

Financial risk

--Pretax interest coverage (the number of times interest costs are covered by pretax earnings).

--Common equity ratio (the percentage of total permanent capital that is contributed by common stockholders).

Operating efficiency

--Gross plant turnovers (the number of times gross revenues exceed gross plant valuation).

1/Class A utilities are those with operating revenues of $2.5 million or more.

2/Class B utilities are those with annual revenues of $1 million or more but less than $2.5 million.

Quality of earnings

--Allowance for funds used during construction (AFUDC) (interest on funds used for construction projects that has been capitalized and credited to current income--expressed as a percent of income).

Profitability ratios

--Earnings per share (the net amount from earnings that is available to common stockholders).

--Return on common equity (the earnings available to common stockholders after preferred dividends have been paid--expressed as a percent of common equity).

--Return on total capital (gross income as a percent of total permanent capital).

Market assessment of risk

--Price-earnings ratio (the earnings per share divided into the market price of the stock).

--Market-to-book ratio (the market price of common stock divided by its book value).

The study concluded that (1) financial risks of electric utilities had increased significantly, (2) rating agencies had acknowledged the increased risk by dropping utilities' bond ratings, and (3) electric utilities were in a poor position to attract additional capital.

The FPC staff also noted that, among the many problems which emerged during the rapidly changing economic and financial environment of the last few years, two problems demanded immediate attention. The first problem concerned the utilities' liquidity positions--they were suffering from an acute cash shortage. The second problem involved the utilities' rates of return on investment--either the utilities could not earn the rate of return authorized by the regulatory authorities or the rate of return authorized was inadequate.

To help alleviate the problems identified, either directly or indirectly, the OAP staff suggested eight policy options, one of which was to allow the CWIP cost to be included in a utility's rate base. Among the other options were provisions to (1) increase investment tax credits, (2) base allowable rates of return on future costs instead of historical test periods, (3) use tax-exempt bonds for

pollution-control facilities, (4) expand the use of automatic adjustment clauses, and (5) allow utilities to account for the difference between taxes collected and taxes paid over a longer period of time.

While preparing the study, OAF identified 27 electric utilities and 5 electric utility holding companies that appeared to be in a relatively weak financial condition in relation to the other companies studied. The 5 holding companies represented 25 electric utilities; therefore, as many as 52 utilities were in questionable financial condition in September 1974. The OAF staff did not identify the specific problems causing the utilities' financial difficulties. An OAF official said that in many cases FPC had limited jurisdiction over the companies and could offer little help other than to increase the utilities' rates of return on wholesale sales and to limit suspensions on rate increase filings to 1 day. Although it considered assistance through the regulatory process to be a State prerogative, FPC had not made any efforts to work with State commissions in solving these financing problems.

Current assessment of utilities' financial conditions

There is little question that the utility industry has rebounded financially from the circumstances it found itself in during 1974 and early 1975. FPC staff studies and memorandums indicate that, with some exceptions, the overall financial conditions of the utilities have improved and that much of the rationale for allowing CWIP in the rate base no longer applies.

This assessment confirmed our analysis of the current situation in which we used essentially the same utilities as were used in FPC's 1974 study. We used eight of the nine financial indicators (previously defined) included in FPC's 1974 study and added data for 1974 and 1975 as shown below.

Year	Pretax interest coverage	Common equity ratio	Allowance for funds used during construction	Return on average total capital	Earnings per share	Return on common equity	Price-earnings ratio	Market-to-book ratio
1971	3.57	35.82%	20.54%	7.81%	$2.18	11.77%	12.22	1.47
1972	3.59	35.70	23.42	8.12	2.36	12.30	10.68	1.36
1973	3.36	35.74	30.03	8.02	2.28	11.56	9.78	1.15
1974	2.96	35.20	34.50	7.90	2.17	10.73	7.88	0.85
1975	3.07	34.88	29.22	8.51	2.37	11.58	7.00	0.84

Using 1971 statistics as the base year, the analysis shows a gradual decline in the utilities' financial conditions through 1974, with a general recovery starting in 1975. The two major exceptions to the improvement were the price-earning ratio and the market-to-book ratio, both indicative of the market's uncertainty as to the utility industry's future financial stability. This questionable investment potential is also shown in the continued decline in the percentage of common equity used to finance the industry. The remaining five indicators showed measured improvement from 1974 to 1975, with earnings per share exceeding the 1971 level.

Various analyses completed by respected financial services indicate that the improving trends should continue in 1976. Two such analyses by the Argus Research Corporation and the Value Line Investment Survey demonstrate this optimism. The Argus analysis predicts many companies will undergo upward price-earnings ratio evaluations and the quality of utility earnings will improve. The Value Line Survey predicts that the "electric-utility industry has recovered from its worst slump in decades" and also indicates that the quality of utility earnings will improve. Therefore, it appears the utilities' financing problems are being alleviated, at least to some extent, by improved market conditions.

FPC did little to assess the CWIP issue and the necessity for the rulemaking until nearly 16 months after the initial proposal was publicly announced.

On March 18, 1976, a memorandum from the Office of Economics to the Office of the Commissioners suggested that FPC consider rate filings on a case-by-case basis and only allow CWIP in the rate base when a company meets the following criteria:

--The company needs the plant expansion or improvement to supply energy with reasonable reliability in conjunction with environmental and public policy objectives.

--External capital markets are either too costly or totally unavailable to meet the capital needs of such expansion and improvement.

This memorandum also highlights several reasons for including CWIP in the rate base. However, the information in the memorandum that provides support for including CWIP is based on 1974 data.

APPENDIX I

In July 1976 OAF prepared "A Study of the Capital Needs and Capital Attraction Ability of the Electric Utility Industry." This study indicated that a general concensus seems to be that the financial condition of the industry is much improved over the conditions that existed 2 years ago. Utility companies' customer growth, sales, revenues, and income available for common stockholders have generally increased, and business and financial risk has been reduced.

The Office of Economics submitted another memorandum to the Commissioners on August 23, 1976. This memorandum recommended (1) FPC permit pollution control and conversion costs in the rate base if the costs could be defined to avoid adjudication and (2) FPC leave open the possibility of permitting additional CWIP in the rate base if certain conditions were met. However, using financial data available through March 1976, the staff pointed out that the 1974 rationale for including CWIP is no longer applicable and that prompt regulatory action by FPC and State commissions is more valuable than FPC allowing CWIP in the rate base.

Conclusions

We believe that, in view of the improving financial condition of the electric utility industry, a more definitive analysis of the immediate need for the rulemaking should have been made before the final decision. This analysis should have included as a minimum (1) an assessment of the current financial condition of the utility industry, particularly for options available for financing environmental facility costs and utilities in a precarious financial position and (2) a critical evaluation of the policy options proposed in 1974, their implementation status, and their potential for providing the financial assistance required by the utility industry or by individual utility companies in today's environment.

POTENTIAL IMPACT OF THE PROPOSED RULEMAKING

FPC intended that the immediate impact of the proposed rulemaking would be to improve the cash flow of the utility companies. A secondary purpose of the rulemaking was to minimize the impact of the AFUDC account and improve the utilities' "quality of earnings" by reducing the percentage of noncash income credited to the earnings account.

The rulemaking Order No. 555, issued on November 8, 1976, appears to achieve neither of these objectives. The near-term dollar impact of the rulemaking on utility earnings is expected to be relatively small. The extent of any future

effects will depend on FPC's acceptance of a utility company's claim of financial hardship and approval of its petition to include CWIP costs in the rate base to alleviate the hardships.

A more important impact of the rulemaking order may be on FPC's ability to adequately regulate the industry. The FPC staff is already burdened with a backlog of rate filing cases that continues to grow. Increased numbers of rate filing cases are not anticipated. However, the present limitations in the order as to the evironmental costs that will be considered and the uncertain definitions of these costs could require more detailed analysis of the cases by the staff and might result in extended hearings for each case. In addition, the in extremis provision of the order makes it mandatory that the staff accept for filing each rate increase case and analyze every case submitted with CWIP in the rate base.

Current method of accounting for construction costs

FPC has consistently refused to allow a utility to include CWIP costs in its rate base until such facilities become "used and useful." Until such time as the facility is completed and put into service, construction costs are accumulated in a CWIP account.

As construction is completed, the associated costs are transferred from CWIP to the utility's plant-in-service account. When FPC approves, the costs are considered as part of the rate base for ratemaking purposes and the utility is allowed to begin depreciating the asset and earning a rate of return.

For many years, prescribed systems of accounts for regulated companies have considered the actual and imputed interest costs for externally and internally generated construction funds to be legitimate construction costs. Under FPC's Uniform System of Accounts, utilities use an AFUDC account to record actual interest cost for externally generated construction funds and an imputed interest cost for the use of funds internally generated. These interest costs accumulate during the construction period, and when the plant under construction is placed in service, the related AFUDC expense becomes part of the rate base along with direct construction costs. The interest costs are recovered in utility rates through the depreciation expense allowance the same as for physical

assets. The allowed rates also include a return on the unrecovered AFUDC amounts in the same manner as any other unrecovered plant costs.

Although both the AFUD and CWIP accounts represent capitalized costs that are recovered over the life of the asset, there is one major difference. The AFUDC amounts capitalized each year in the accounting records are accounted for as income in the annual financial statements even though there is no matching cash flow to the utility until the construction work is completed. As the amount of interest capitalized each year has grown larger, financial analysts have tended to view this increasing proportion of utility noncash income as "poor quality" earnings. This market assessment of earnings has reportedly made it difficult for utility companies with large construction programs to borrow funds at favorable interest rates and has been a matter of FPC concern.

Financial impact of the rulemaking order

The financial impact of the rulemaking can be determined with some degree of certainty only for the FPC-regulated wholesale electric power market. Even if the provisions of the order were to be incorporated into all State regulatory guidelines, the total effect would be greatly reduced because nearly one-half of the State commissions currently allow their jurisdictional utilities to include some or all CWIP cost in their rate bases.

FPC has estimated that, if the $1.558 billion in construction costs for pollution control equipment reported in 1975 by jurisdictional utilities had been allowed in rate bases and wholesale rate schedules had been adjusted, rates would have increased by less than 1 percent. On the basis of our own analysis, which included a factor for CWIP allowed by State commissions, we estimated the increase could have been as little as $11.8 million dollars, or 0.2 percent of total wholesale revenues reported.

FPC is projecting, however, that the wholesale rates could initially increase to between 1 and 2 percent and become a larger percent of total CWIP over the next 5 years. This change includes the need for more utilities to retrofit air pollution control equipment in existing coal plants, in plants converting to coal, and the expected large proportion of coal plants in new construction with their need for controls.

The impact of the in extremis provision appears to be important but is more difficult to estimate. A sudden downturn in the financial viability of the utility industry could result in a number of rate filings with CWIP in the rate base by utilities with large construction programs and financial difficulties. FPC approval of these rate filings could cause large increases in wholesale rates for some customers of utilities that are largely FPC jurisdictional, but the extent of these increases cannot be determined.

The in extremis provision allows FPC to provide prompt assistance to utilities in financial trouble. However, it also appears to reduce the incentive for a utility company to operate in an efficient and prudent manner.

The rulemaking order does not appear to have much impact on improving the utilities' "quality of earnings" by reducing the amount of AFUDC-generated noncash income. However, there is some question that even this FPC concern may not be justified. The OAF study of July 1976 reported that electric power companies floated $1,365 billion in bonds (16 percent of all corporate bond offerings) during the first quarter of 1976. The study stated there were no known instances where an electric utility was unable to raise debt capital during that period. The study concluded that debt capital at prevailing interest rates could probably be raised by the utility industry at competitive costs; i.e., the costs incurred by other sectors of industry.

The rulemaking order as approved will not affect much of the current CWIP and AFUDC accounts. As of December 31, 1975, the amount of CWIP affected by the order represented only about 6 percent of total CWIP and the capitalized interest costs would be only a fraction of that amount. However, if a utility in financial distress filed to have its CWIP included in rate base and FPC approved the filing, the AFUDC account for that utility could be reduced and more cash income would be generated.

Additional administrative burden should be considered

In addition to the impact already discussed, we believe that the Commissioners have not given sufficient recognition to the additional administrative load the rulemaking will place on its already overburdened regulatory staff. The FPC staff is currently facing a large backlog of rate increase cases which continues to mount. FPC recognizes the regulatory lag problem and is taking steps to alleviate the

situation. Despite its efforts, FPC expects the existing backlog which existed on June 30, 1975 to increase by 50 percent by the end of fiscal year 1977 without considering the additional impact that would be caused by allowing CWIP in the rate base. We discussed this problem and FPC's response in our report on "Management Improvements Needed in the Federal Power Commission's Processing of Electric-Rate-Increase Cases," (EMD-76-9, Sept. 7, 1976).

Although the Commission is not necessarily expecting an increase in the number of rate increase filings by utilities, the complexity of the filings will undoubtedly increase the analytic requirements by the FPC staff. It does not appear that the definition of the environmental costs to be included in the rulemaking is sufficiently clear to avoid an additional burden in terms of workload, suspension period, and refund provisions. The addition of the in extremis provision requires that each rate increase filing submitted with CWIP as a rate base element must be analyzed by the staff and included as an item to be considered in the regulatory process to determine the justification for adding CWIP to the rate base. This could also add to the complexity of the hearing process and to the staff workload.

Conclusions

The rulemaking order does not appear to adequately serve either of the purposes FPC initially envisioned in November 1974. The immediate financial impact appears to be minimal and little change will result in the utilities' AFUDC accounts.

More importantly, however, the rulemaking sets a precedent for FPC to depart from its historic "used and useful" policy and provides an opening for utilities to submit future rate increase filings with CWIP in the rate bases.

The greatest impact of the rulemaking will probably be to increase the administrative workload of the FPC staff, thereby intensifying the regulatory lag problem. This situation is likely to result because of the more detailed analysis of rate filings required by the FPC staff in assessing (1) the propriety of environmental costs incurred and (2) the financial need of the utility submitting the rate filing.

community level. Among these were inadequate ERR analysis and documentation, failure to consider alternatives and modifications, and difficulties in the historic preservation review process.

Actions needed to improve the quality of necessary environmental reviews

HUD's participation in the environmental review process has generally been limited to (1) providing training and other guidance to communities, (2) monitoring community performance, and (3) approving the release of grant funds based on community certification of compliance with HUD and NEPA requirements.

However, to improve the quality of their ERRs, communities need increased training and better guidance and HUD needs to do more effective monitoring. HUD sould assume an expanded role in responding to these needs.

Training and guidance needed

The need for increased training and better guidance is supported not only by the questionable quality of community environmental reviews but also by the number of communities citing problems.

For example:

--Of the 26 communities we visited, 22 had problems with their envirormental reviews, including 10 communities which had difficulty determining the scope of the review or designing an acceptable ERR format.

--A study performed by the HUD Central Office in September 1976 showed that communities were having problems (1) identifying environmental conditions and impacts and determining their significance, (2) identifying and obtaining required data, and (3) deciding whether to consider project modifications and alternatives. A number of communities also believed a problem had been caused by HUD's contradictory or inadequate advice. The study indicated that community problems have diminished since fiscal year 1975.

--A study conducted by the Pennsylvania Department of Community Affairs early in 1976 showed that 29 of

the 74 communities responding to a questionnaire had problems with the environmental review process. Many of the problems directly related to the quality of guidance received.

An EPA representative, after reviewing ERRs referred by us, expressed his opinion that communities are badly in need of environmental training. EPA representatives from Region II in New York expressed similar opinions after reviewing environmental evaluations prepared by communities in that region. Also, as discussed on page 15, HEW was critical of the guidance given to the communities.

The HUD Inspector General audit discussed on page 16 cited several reasons for the deficiencies observed in community environmental reviews. These include (1) lack of employee training and experience in environmental matters, (2) inadequate guidance and assistance, (3) omissions and lack of clarity in the environmental regulations, and (4) the possibility that some communities may not have fully understood or accepted their environmental responsibilities. The Inspector General report concluded that communities "urgently need substantive training and assistance" to perform their environmental responsibilities.

Communities also believe they need training in the environmental review process. For instance, over 85 percent of the communities responding to the Pennsylvania Department of Community Affairs questionnaire indicated that such a need exists.

HUD's philosophy on training community environmentalists has been to decentralize responsibility to its field offices. No training programs have been developed and implemented by HUD's Central Office for community environmentalists.

HUD regional offices have generally allowed area offices under their jurisdiction to provide technical assistance through monitoring visits or other contacts with community representatives or by formal training sessions. Eight of the nine HUD area offices we visited, for example, have sponsored community development seminars which included environmental concerns as part of the agenda. In addition, all of these area offices made monitoring visits and had other contacts with communities in their jurisdiction. Although we were unable to obtain specifics regarding the quality of HUD training or the scope of community coverage, only 11 of 26 community representatives we interviewed could

recall having attended HUD-sponsored seminars. However, 24 of the 26 did acknowledge telephone or personal contacts with HUD representatives.

HUD recognizes that communities are in need of environmental training and guidance and, since the inception of the block grant program, various steps have been taken to meet these needs in addition to those described above, as follows:

--In-house training has been provided to HUD field office personnel.

--HUD staffs have participated in environmental seminars given by State and local agencies.

--Some HUD regional offices have provided unique technical assistance to communities, such as the Kansas City's issuance of a directory to provide grantees with a list of sources for technical assistance, and the New York Region's use of closed circuit television seminars.

--HUD awarded a contract on September 30, 1976, for the development of a program for training community environmentalists.

To further aid communities in the execution of their environmental responsibilities, HUD distributed two technical publications for use in performing environmental reviews. Both "Environmental Reviews at the Community Level--A Program Guide" which was published in October 1975, and "Interim Guide for Environmental Assessments" which was sent to communities in May 1976, were intended as guidance. Use of the publications is not mandatory. The use of either publication could help assure consideration of all environmental factors prescribed in the HUD regulations and provide communities with an acceptable ERR format.

The HUD Inspector General audit cited the lack of a HUD prescribed ERR format as one reason for the reported deficiencies. In this connection, of the nine communities whose first-year ERRs we evaluated, only five were planning to utilize all or some variation of the format in the above-mentioned publications in preparing ERRs for their second program year.

Improved monitoring needed

To assure that communities are effectively complying with HUD's environmental regulations, HUD needs to improve its monitoring program by performing more indepth evaluations of ERRs.

HUD regional offices were delegated responsibility for developing and implementing systems for monitoring grantee performance. Regional monitoring systems were designed to meet general requirements established by HUD Central Office and were to include various types of monitoring activities conducted by the HUD area offices, including (1) scheduled site visits by program representatives for coverage of the entire community development program at varying levels of intensity and (2) special site visits to provide intensive coverage of special problem areas such as the environment. Special site visits for environmental monitoring are usually made by environmental clearance officers assigned to the area office.

For environmental monitoring, HUD Central Office has specified that "monitoring should be directed toward ascertaining procedural compliance." For example, HUD field personnel are to determine whether the community has prepared an ERR for each project and whether the community has generally complied with HUD environmental regulations for such required elements as (1) describing projects, (2) determining existing environmental conditions, (3) identifying environmental impacts, and (4) considering modifications and alternatives. However, HUD field offices are not required to question the adequacy of community decisions concerning the significance of environmental impacts or determine whether all environmental impacts have been identified and assessed.

In developing monitoring guidelines, HUD field offices generally followed Central Office direction to monitor only the procedural aspects of community environmental reviews. Although some HUD field personnel do more detailed monitoring during individual visits, we were informed that in-depth evaluations of the adequacy of community environmental decisions and the substantive quality of environmental assessments is not normally being accomplished during HUD monitoring visits.

Regional offices are required to submit quarterly reports of their monitoring activities to the Central Office. For the 9-month period January 1, 1976, to September 30,

1976, these reports showed that 357 special site visits for environmental monitoring had been made by the 10 HUD regional offices.

The Central Office analysis of the environmental findings showed that various problem areas had been identified by the HUD field offices. The majority of these problems were of a procedural nature (i.e., improper drawdowns of grant funds; improper advertising to the public; and inadequate ERR documentation). However, several HUD regions did identify substantive problem areas (e.g., identification and assessment of environmental impacts; and historic analysis).

CONCLUSIONS

We believe that environmental reviews are not needed in many cases because of the environmental insignificance of some types of community projects. For such projects, realistic determinations can be made before any detailed review that expected impacts will not be significant.

Elimination of environmental reviews for certain types of projects would streamline the review process and allow communities to (1) have more immediate use of grant funds, (2) have more grant funds available for projects, and (3) perform more effective reviews for significant projects.

Also, some communities are not effectively carrying out their responsibilities because, in performing environmental reviews, they are not

--totally describing the work to be performed or defining the environmental conditions existing in project areas,

--identifying and evaluating all environmental impacts of proposed projects,

--considering modifications to or alternatives for proposed projects, or

--performing the required historic analysis of properties in project areas.

We believe these problems have resulted from inadequate training of and guidance to community environmentalists. We also believe that these problems will continue if indepth evaluations of community environmental reviews are not made by HUD.

RECOMMENDATIONS

To make the environmental review process easier and to make sure that communities carry out their responsibilities, the Secretary of Housing and Urban Development should:

--Work with the Council on Environmental Quality to identify, and exempt from review, those insignificant types of projects which do not need environmental reviews.

--Clarify and expand the Department's environmental review procedures, particularly the scope of environmental reviews required by communities.

--Establish a mandatory environmental review format for communities to use.

--Emphasize training of community environmentalists.

--Revise the Department's monitoring procedures, so communities' environmental reviews are evaluated indepth.

AGENCY COMMENTS AND OUR EVALUATION

We provided CEQ, EPA, HUD, and HEW with the opportunity to comment on the matters discussed in the report. Their comments follow. (See apps. II through V for the agencies' responses.)

CEQ

The Council said that the report's recommendations would greatly improve the environmental review process for the block grant program and were basically similar to its own evaluation and recommendations.

EPA

EPA essentially agreed with the conclusions reached in the report. EPA said the report findings coincided with its own experience with the program. In addition, EPA said that the recommendations seem eminently reasonable.

HEW

HEW agreed that HUD need not attempt to review the environmental impact of all Federal actions, and that HUD

should identify those programs and activities which do not have the potential for producing an environmental impact--and exclude them from unnecessary and time consuming paperwork. However, HEW said care must be taken because historic properties are not always thought of in terms of environmental protection and there should be some provision for review of actions with potential for producing impacts on historic properties.

HEW's concern regarding historic properties is well taken. In developing our criteria to classify projects which we believed to be environmentally insignificant, we recognized that for some projects a determination of the projects' effect on historic properties may be necessary. (See p. 8.)

HEW also said that there was a need for technical assistance to those intimately involved in program affairs in order to improve the quality of environmental documents.

HUD

HUD agreed with our recommendations and plans to implement them as discussed below. HUD said that our findings were substantially in agreement with its December 1976 Inspector General audit report and other information which has come to its attention. HUD said it was soliciting criticism of the existing regulations (24 CFR Part 58) and suggestions for their improvement before making a major revision of the environmental procedures in the fall of 1977 which will include identifying the types of activities unlikely to involve significant adverse environmental impacts and exempting them from the current procedural requirements. In addition, HUD said that it will

--expand and clarify the revised regulations to better define the scope of reviews which are required of communities,

--require a standard ERR format, and

--revise its monitoring procedures to reflect its concern about substantive compliance with the objectives of the 1974 act.

Finally, HUD said that the need for training grantees in the environmental review process is unquestioned and the development of a training program should be completed by late summer 1977. The first courses under this program are scheduled for September 1977.

We believe the above actions, if properly implemented, should resolve the problems discussed by our review.

CHAPTER 3

SCOPE OF REVIEW

We made our review at HUD Central Office in Washington, D.C.; 4 HUD regional offices; 9 HUD area offices; and 26 communities in 8 States. (See app. I for listing of HUD and community locations.)

We reviewed environmental and grant files and other documents and reports. We also interviewed officials and other representatives of HUD, communities receiving block grants, EPA, HEW, CEQ, and consulting firms hired by communities to make environmental reviews.

For 9 of the 26 communities visited, we evaluated the adequacy of their environmental reviews--supplementing our evaluations with technical input from EPA and HEW regional offices in Philadelphia, Pennsylvania.

For all 26 communities visited, we examined a selected number of environmental reviews to determine the types of projects being assessed and evaluated the need for such assessments.

HUD REGIONAL AND AREA OFFICES AND COMMUNITY LOCATIONS VISITED DURING OUR REIVEW

HUD			Communities	
Region	Location	Area office	Location	Fiscal year 1975 grants (thousands)
2	New York, N.Y.	Camden, N.J.	Camden, N.J.	$ 5,554.0
			Vineland, N.J.	1,519.0
			Burlington County, New Jersey	509.0
			Trenton, N.J.	5,097.0
		Newark, N.J.	New Brunswick, N.J.	1,399.0
			Lambertville, N.J.	84.0
3	Philadelphia, Pa.	Philadelphia, Pa.	Philadelphia, Pa.	60,829.0
			Harrisburg, Pa.	2,482.0
			Lancaster, Pa.	4,208.0
			Scranton, Pa.	7,747.0
			Reading, Pa.	4,186.0
			Carlisle. Pa.	210.0
			Wilmington, Del.	4,490.0
		Pittsburgh, Pa.	Allegheny County, Pa.	6,456.0
			Monessen, Pa.	2,069.0
		Baltimore, Md.	Baltimore, Md.	32,749.0
7	Kansas City, Mo.	Kansas City, Kans.	Kansas City, Mo.	17,859.0
			Kansas City, Kans.	6,206.0
			Arkansas City, Kans.	274.0
			Omaha, Neb.	1,390.0
		Omaha, Neb.	Lincoln, Neb.	486.0
9	San Francisco, Calif.	San Francisco, Calif.	Berkeley, Calif.	2,812.0
			Fresno, Calif.	10,038.0
		Los Angeles, Calif.	Los Angeles County, Calif.	10,099.4
			Anaheim, Calif.	511.0
			Baldwin Park, Calif.	118.4

APPENDIX II

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410

June 30, 1977

OFFICE OF THE ASSISTANT SECRETARY
FOR COMMUNITY PLANNING AND DEVELOPMENT

IN REPLY REFER TO:
CSM

Mr. Henry Eschwege
Director, Community and Economic
Development Division
General Accounting Office
Washington, D. C. 20548

Dear Mr. Eschwege:

This is in response to your May 12, 1977 draft report: Community Development Block Grant Environmental Reviews At The Community Level: Are They Needed? Are They Adequate?

The findings of your report are substantially in agreement with the findings made in the audit report issued December 29, 1976 by HUD's Office of Inspector General and with other information which has come to my attention. They support your recommendations, which I find most helpful and which I intend to implement, as follows:

On May 16, 1977, we published in the Federal Register a Notice of Proposed Rulemaking (42 FR 24755), soliciting comments from agencies and the general public concerning the Community Development Block Grant (CDBG) Environmental Procedures which are contained in 24 CFR Part 58. The Notice, a copy of which is enclosed, also solicits criticisms of the existing regulations and suggestions for their improvement. We plan a major revision of these procedures in the early Fall, utilizing comments received in response to the Notice, from your audit and the one conducted by our own Inspector General and any changed national policy guidelines emanating from the proceedings currently underway at the Council on Environmental Quality.

More specifically, we do intend to identify types of activities which are unlikely to involve significant adverse environmental impacts and exempt them from the procedural requirements of 24 CFR Part 58. Long before joining HUD, I recognized the need for this and action to bring it about was one of my first priorities upon assuming office.

When these regulations are revised, they will be expanded and clarified, not with a view toward increasing their complexity, but, as your report suggests, to better define the scope of reviews which are required to be carried out by communities.

APPENDIX II

The environmental review record format contained in the guidebook Environmental Reviews At The Community Level will, as you recommend, become a required format. This should aid the communities in the formulation of their administrative records and will aid HUD in its monitoring efforts. It will also bring an element of uniformity to the procedures, the lack of which has, in the past, made it difficult for HUD staff to assess performance.

I am aware that the Department's monitoring policy has, in the past, focused primarily upon the review of procedural compliance. However, that limited policy is not the policy of this administration, as the Secretary has informed the Subcommittee on Housing and Urban Affairs of the Senate.

Our concern about substantive compliance with the objectives of the Housing and Community Development Act of 1974 was communicated to both HUD personnel and to the CDBG grantees on April 15, 1977. Also, on April 6, 1977, I advised our Field Offices that the CDBG Monitoring Handbook (6500.1), mentioned in your report, will be revised to reflect this new policy and we are now in the process of seeking Field Office recommendations on such revision. We intend to preserve local initiative and flexibility in the CDBG Program, but I can assure you, we shall better inform ourselves in the future as to the substantive performance of its grantees.

The need for training CDBG grantees in the environmental review process is unquestioned; the feasible method of providing it is difficult to identify. As you point out, there are several thousand communities and they are not easily categorized in terms of need for this kind of training.

We have, as you mentioned, contracted for the development of a training program. This should be completed by late Summer, but I cannot, at this time, indicate exactly how, or to what extent, we will be putting it into effect. I can report that we have scheduled, as a test, the first two one-week courses of training under this program. These will be held the weeks of September 12-16 and September 26-30, 1977.

I can assure you that to the extent our resources permit, we shall make every effort to provide the kinds of training and guidance which your report demonstrates is needed at the local level. We shall, for instance, through our changes in monitoring policies, become more directly available to the localities than we have been in the past and more willing to express objective judgments about local performance. This, in itself, will serve as a means of delivering training and technical guidance considerably more extensive than has been delivered previously.

Your report is most constructive and helpful and I want you to know it is received with appreciation.

APPENDIX II

[See GAO note below.]

While the matters contained in your report will be taken into account by us when we undertake to revise 24 CFR Part 58, it occurs to me that you, or members of your staff might have additional comments, suggestions or criticisms not mentioned in the report. If this is the case, your additional response to the attached Notice would be most helpful.

Sincerely,

Robert C. Embry, Jr.
Assistant Secretary

GAO note: The deleted comments relate to matters which were discussed in the draft report but omitted in this final report.

APPENDIX III

DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20201

JUN 10 1977

Mr. Gregory J. Ahart
Director, Human Resources
Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Ahart:

The Secretary asked that I respond to your May 13 request for the Department's comments on your draft report, "Community Development Block Grant Environmental Reviews at the Community Level: Are They Needed? Are They Adequate?" Our comments, prepared by the Office of Environmental Affairs, are enclosed.

We appreciate the opportunity to comment on this report in draft form.

Sincerely yours,

Thomas D. Morris
Inspector General

Enclosure

Comments of the Department of Health, Education, and Welfare (Office of Environmental Affairs) on the General Accounting Office Draft Audit Report, "Community Development Block Grant Environmental Reviews at the Community Level: Are They Needed? Are They Adequate?"

The Office of Environmental Affairs has reviewed the subject report and has the following comments:

A key message contained in the GAO report is that HUD (and other agencies) need not attempt to review the environmental impact of all Federal actions, and that HUD (and the other Federal agencies) should identify those programs and activities which do not have the potential for producing an environmental impact--and exclude those actions from unnecessary and time-consuming paperwork.

The Office of Environmental Affairs concurs with this approach, and in fact, implements the approach in its Generic Review process. However, care must be taken in using this approach on historic properties and other protected assets which are not always thought of in terms of environmental protection. Some of those activities identified by GAO would, based upon the experience of this office, appear to have the potential for producing impacts on historic properties. GAO's approach therefore should contain some provision for review of the actions with this in mind.

The GAO report also speaks to the need for technical assistance to those intimately involved in program affairs in order to improve the quality of environmental documents. The Office of Environmental Affairs concurs in this approach. While the opportunities are limited for this office to engage in technical assistance, the need exists and with required resources, we would be more heavily engaged in this activity.

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL ON ENVIRONMENTAL QUALITY
722 JACKSON PLACE, N W
WASHINGTON, D C 20006

JUN 7 1977

Dear Mr. Eschwege:

Thank you for your May 12 letter requesting the Council's comments on your draft report examining environmental responsibilities in the community development block grant program of the Department of Housing and Urban Development.

The Council believes that the report's recommendations would greatly improve the environmental review process for the block grant program, and we encourage you to issue the report as soon as possible. We have recently completed our own evaluation, and our recommendations are basically similar. A copy of our report is enclosed.

Thank you for providing us the opportunity to comment on your report.

Sincerely,

J. Gustave Speth
Member

Mr. Henry Eschwege
Director
Community and Economic Development Division
General Accounting Office
Washington, D.C. 20548

Enclosure

cc: Honorable Patricia R. Harris
Secretary of Housing and Urban Development
Washington, D.C. 20410

APPENDIX V

UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

JUL 15 1977

OFFICE OF
PLANNING AND MANAGEMENT

Mr. Henry Eschwege
Director, Community and
Economic Development Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Eschwege:

We have reviewed your draft report on "Community Development Block Grant Environmental Reviews at the Community Level: Are They Needed? Are They Adequate?", and essentially agree with the conclusions reached. The findings it contains coincide with our experience with this program, and the recommendations which the General Accounting Office has based on these findings seem eminently reasonable to this Agency.

Sincerely yours,

Acting Assistant Administrator
for Planning and Management

APPENDIX VI

PRINCIPAL OFFICIALS OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT RESPONSIBLE FOR ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
SECRETARY OF HOUSING AND URBAN DEVELOPMENT:		
Patricia Roberts Harris	Jan. 1977	Present
Carla A. Hills	Mar. 1975	Jan. 1977
James T. Lynn	Feb. 1973	Feb. 1975
ASSISTANT SECRETARY FOR COMMUNITY PLANNING AND DEVELOPMENT:		
Robert C. Embry, Jr.	Mar. 1977	Present
John Tuite (acting Deputy)	Jan. 1977	Mar. 1977
Warren H. Butler (acting)	Nov. 1976	Jan. 1977
David O. Meeker, Jr.	Mar. 1973	Sept. 1976

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